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SUBMISSION

to the

ONTARIO COMMITTEE ON TAXATION

**THE TAX TREATMENT
OF CO-OPERATIVES
AND THE ECONOMIC EFFECTS
OF THEIR PRESENT
TAX-FAVORED STATUS**

**Robert T. Patterson, M.A., Ph.D.
Economic Consultant to
The Equitable Income Tax Foundation**

TORONTO, Ontario

JANUARY 23, 1964

THE EQUITABLE INCOME TAX FOUNDATION

S U B M I S S I O N

to the

ONTARIO COMMITTEE ON TAXATION

Presented By

ROBERT T. PATTERSON, M.A., Ph.D.

TORONTO, Ontario

JANUARY 23, 1964

S U M M A R Y

Co-operatives, although they are corporations, are to a large extent exempt from the corporation income tax; and all newly established co-operatives are entirely exempted from the tax for three years. Certain provisions of the Canadian Income Tax Act enable co-operatives to avoid a large part of the tax by permitting them, subject to certain restrictions, to deduct from their income the patronage dividends that they pay or allocate to their members.

Although a reduction in the corporation income tax would reduce the advantage now enjoyed by the tax-favored co-operatives, and the elimination of that tax would remove the advantage, the solution of this problem of tax inequality should not wait upon a major revision of the tax system, if that revision is to be delayed. In the meantime some other solution must be sought.

Co-operatives earn the same kind of income as that earned by the fully taxed business corporations. The particular way in which the owner-patrons of a cooperative share in that income does not change the fact that the income is produced through the same processes of value creating and bargaining that produce income for other businesses. The owner-patrons of a co-operative provide the equity capital and assume the risks of the business. Thus, they are just as much investors in a profit-motivated corporate business as are the shareholders in an ordinary corporation.

The present tax privilege of co-operatives is not in the public interest, because it is inequitable and uneconomic. It is inequitable both because it discriminates between two essentially similar sources of revenue and because it results in an unwarranted competitive advantage for the co-operative corporations.

Large tax savings permit many co-operatives to expand far more rapidly than they could if their tax burden were equal to that of their ordinary corporate competitors; and tax free income has enabled co-operatives, in numerous instances, to buy out their ordinary corporate competitors. Often the co-operatives can afford to pay more for such businesses than the businesses are worth to their owners, because when a rival business is acquired and becomes part of a co-operative, its earnings become to a large extent free of tax.

The tax privilege now accorded co-operatives is uneconomic because it causes a poorer allocation of the Nation's resources than would otherwise occur. The competitive advantage resulting from that privilege is conducive to some degree of monopoly power for many co-operatives, and the aid to survival that the privilege provides for inefficient co-operatives distorts the flow of resources from their best uses. An established principle in economics is that the freer markets are from monopolistic and other restraining and distorting influences, that is, the more fairly competitive the economic system is, the closer the economy will be to the most economical use of its capital and manpower.

The subsidy that the tax advantage gives to practically all co-operatives (except those that have no earnings at all and so would not be subject to an income tax) permits many of the inefficient and uneconomically operated ones to survive when otherwise they could not do so; and it permits the more efficient

co-operatives to expand their operations beyond what would be a point of insufficient return if their earnings from that expansion were fully subject to tax.

Only when the use of capital is not distorted by some obstacle such as tax favoritism can the highest possible level of productivity for the Nation's capital resources be achieved. Likewise, the effort of workers is most productive when it is not induced by tax subsidization, or some other arbitrary influence, to remain in inefficient but subsidized business situations. This is not to say, of course, that all co-operatives are inefficient businesses.

The tax savings of the co-operatives are in effect a subsidy or gift to them, whether they are the most prosperous or least prosperous associations. This tax subsidy, while reducing the total flow of real wealth because of the diseconomies that it fosters, is paid through the heavier tax burden that falls upon the rest of the economy.

The question why everyone else should thus contribute to the co-operatives and their members has never been satisfactorily answered. The gain obtained by the co-operators has no justification, for they have done nothing to entitle them to it. It results entirely from the arbitrary provisions of the tax law by which co-operatives receive special favored treatment.

Although there is no accurate way of determining the amount of revenue lost to the Government because of this tax privilege, a reasonable estimate would appear to be at least \$25 million. The addition of such an amount to the Government's receipts would lessen somewhat the overall tax burden.

This tax advantage, which has been accorded the co-operative form of business organizations for many years, undoubtedly has greatly advanced the co-operative movement, which some individuals believe

co-operatives to expand their operations beyond what would be a point of indifference return if their earnings from that expansion were fully subject to tax.

Only when the use of capital is not distorted by some obstacle such as tax favoritism can the highest possible level of productivity for the Nation's capital resources be achieved. Likewise, the effort of workers is most productive when it is not induced by tax subsidization, or some other arbitrary influence, to remain in inefficient and unproductive business situations. This is not to say, of course, that all co-operatives are inefficient businesses.

The tax savings of the co-operatives are in effect a subsidy or gift to them, whether they are the sole proprietors or joint owners. The total tax savings to the Nation is the sum of these gifts. In fact, it is not through the heavy tax burden that this subsidy to the economy is effected. The question now everyone else should thus contribute to the co-operatives and their members has never been satisfactorily answered. The gain obtained by the co-operatives is an illustration, for they have done nothing to utilize their gain.

It results entirely from the arbitrary provisions of the tax law by which co-operatives receive special favored treatment.

Although there is no accurate way of determining the amount of revenue lost to the Government because of this tax preference, a reasonable estimate would appear to be at least \$25 million. The addition of such an amount to the Government's receipts would lessen somewhat the overall tax burden.

This tax advantage, which has been accorded the co-operative form of business organization for many years, undoubtedly has greatly

will result finally in a co-operative State and a co-operative world. In the co-operative State the individual would be subservient to it in every aspect of his economic life. As a consumer he could buy only what the co-operative authorities thought good for him. As worker and investor he would have no choice but to serve the great national co-operative. Other implications for human freedom would be the same that obtain under any system of collectivism. It would seem, however, that only under the most favorable and artificial circumstances, including grossly inequitable tax favoritism, could such an economic system come about.

But how can it be proper public policy to favor by means of discriminatory taxation the establishment, growth, and expansion of co-operatives if they are not a superior form of business? Or if it could be shown that they are superior, why should they have favored tax treatment or any other special privilege rendered by government? The answer is plain: without subsidy of any kind, each co-operative should find its rightful place in a free economy in the same way that other unfavored businesses must. The whole Nation would be better off. Its capacity to produce would be used more fully and effectively.

There is, and always has been a place for the co-operatives in a free economy. How extensive the co-operative form of business may become, and what part of the Nation's total business will be transacted by it, ought to depend solely upon the co-operatives' unsubsidized ability to serve the public economically.

To bring about tax equality for co-operatives and their ordinary corporate competitors the Income Tax Act should be amended so as

- (1) to require co-operatives to pay the corporation income tax without allowance for any deduction of patronage dividends and
- (2) to require the taxation of patronage dividends to the recipients in the same way that the dividends of ordinary corporations are taxed to their recipients.

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JANUARY 23, 1964

TORONTO, Ontario

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99	2.99	2.99.1	2.99.1.1
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SUBMISSION

to the

ROYAL COMMISSION ON TAXATION

by

Robert T. Patterson, M.A., Ph.D.

Economic Consultant

to

THE EQUITABLE INCOME TAX FOUNDATION

1. INTRODUCTORY STATEMENT

1.1 The undersigned is an economist on the staff of the American Institute for Economic Research, Great Barrington, Massachusetts, U.S.A. This Submission, presented to your Commission at the request of The Equitable Income Tax Foundation, was prepared by him in an individual capacity separate from his duties at the Institute.

1.2 During the past decade he has studied the problem dealt with here, and has discussed its various aspects in a book, articles, and Congressional testimony.¹ His study was at first concerned with the income tax status of co-operatives in the United States, but has been more recently concerned also with the income tax status of Canadian co-operatives, the problem being essentially the same in both countries. Throughout this Submission, wherever

¹ The Tax Exemption of Co-operatives, 2d (Revised) edition (University Publishers, New York, 1960). Article on the taxation of co-operatives in the Washington Sunday Star, September 18, 1955. "Competition and the Taxation of Co-operatives," The Commercial and Financial Chronicle, January 19, 1956. "The Tax Exemption of Co-operative Associations," in General Revenue Revision, Hearings before the Committee on Ways and Means, House of Representatives, 85th Cong., 2d Sess., January 21-30, 1958, Part 2 (Washington: Government Printing Office, 1958), pp 1598-1604). Statement on the Tax Treatment of Co-operatives, Hearings before the Committee on Ways and Means, House of Representatives, 86th Cong., 2d Sess., February 1-5, 1960 (Washington: Government Printing Office, 1960), pp. 93-115.

it has seemed appropriate to draw upon past studies in order to further the analysis, he has done so.

1.3 Until last March, when the undersigned was asked by the Equitable Income Tax Foundation to prepare a Submission to be presented to your Commission, he had not had the privilege of knowing anyone connected with the Foundation. The conclusions developed in this Submission, although substantially in accord with the position of the Foundation, were arrived at independently and long before he had any reason to suppose that he should have the honor of offering them for your Commission's consideration.

1.4 The Submission is responsive to the following sections of the Commission's terms of reference:

- (i) the distribution of burdens among the taxpayers resulting from existing rates, exemptions, reliefs and allowances provided in the corporation income tax;
- (ii) provisions in existing laws which may have given rise over the years to anomalies or inequities or which may require action to close loopholes which permit the use of devices to avoid fair taxation;
- (iii) the changes that may be made to achieve greater clarity, simplicity and effectiveness in the tax laws or their administration.

1.5 Conclusions

- (i) Under Sections 73 and 75 of the Income Tax Act, co-operative business corporations can and do escape a large part of the tax that

falls upon other business corporations.

- (ii) Although spokesmen for the co-operatives have formulated doctrines and devised special terminology in an attempt to justify their organizations' tax-favored status, the incontrovertible fact remains that the co-operatives are business corporations earning the same kind of income as that of the fully taxed ordinary corporations.
- (iii) Co-operatives are not eleemosynary associations, nor are they partnerships or agencies. They are corporate business enterprises seeking gain for their members.
- (iv) The marked tax discrimination favoring co-operatives cannot be shown to be in the public interest, because it leads to less than the fullest use of the Nation's resources.
- (v) The co-operatives' tax advantage could conceivably be the opening wedge for a collectivist society, in which the form of business organization would be predominantly or exclusively co-operative, with all the adverse implications for economic freedom that are inherent in centralized, over-all direction and control of economic processes.
- (vi) The loss of revenue to the Government, due to this tax discrimination, although of less importance than the resulting inequities and diseconomies, should be taken into consideration.

- (vii) The discrimination is inequitable not only because it taxes heavily one form of business corporation while taxing lightly another, but also because the whole tax burden is thereby made somewhat heavier for all who have to bear it.
- (viii) The present high rates of the corporation income tax have intensified the effects of the discrimination both by making co-operative membership highly advantageous in many instances, and by allowing, through retained earnings lightly taxed, a more rapid expansion of co-operative enterprise than is economically justified.
- (ix) The greater profitability and the competitive advantage of co-operatives, due to their favored tax status, have been a strong inducement for some ordinary corporations to sell out to their co-operative rivals or to transform themselves into co-operatives.
- (x) The tax advantage has given some co-operatives the power to destroy or absorb their heavily taxed competitors, even when the latter may be more efficient businesses.
- (xi) Under conditions of tax equality, the co-operative corporations would pay the full corporation income tax without allowance for any deduction of patronage dividends, and patronage dividends would be taxed to the recipients in the same way that the dividends of ordinary corporations are taxed to their recipients.

- (xii) The problems arising from tax provisions that grossly favor the co-operatives can be solved by legislation that would place co-operatives and their members on the same basis as ordinary corporations and their stockholders with respect to the income tax.

1.6 Recommendations

- (i) That Section 73 (1) of the Income Tax Act, which provides full exemption from the income tax for three years for newly-formed co-operatives, be repealed;
- (ii) That Section 75 of the Income Tax Act be so amended that patronage dividends, whether of co-operatives or of ordinary corporations, no longer be deductible in computing taxable income;
- (iii) That patronage dividends be taxed to the recipients in the same way that the dividends of ordinary corporations are taxed to the recipients, and that whatever deduction or credit is allowed for either kind of dividend be allowed for the other.

1.7 The Submission is developed in accordance with the following outline:

1. Introductory Statement
2. Broader Aspects of Taxation
 - A. Preliminary Considerations
 - B. Economic Effects of the Personal Income Tax
 - C. Economic Effects of the Corporation Income Tax
 - D. Some Generalizations

3. The Problem of Co-operative Tax Privilege and Its Setting
4. How Spokesmen for the Co-operatives have Sought to Justify the Tax Advantage
 - A. The "Infant Form of Business Organization" Argument
 - B. Semantic Confusion: Synthetic Words and Phrases and the Specialized Use of the Term "Co-operative"
 - C. Four Theories of Exclusion
 1. The Partnership Theory
 2. The Price-Adjustment Theory
 3. The Agency Theory
 4. The Debt-Payment Theory
5. The Controlling Fact: Co-operatives have the Same Kind of Income as that of Business Corporations which are Fully Subject to the Income Tax.
 - A. The Nature of Business Income
 - B. How Co-operatives obtain Income
 - C. Capital as a Source of Co-operatives' Income
 - D. The Member-Patrons of a Co-operative are "Owner-Enterprisers of a Profit-Seeking Business"
 - E. The Problem of Determining Co-operatives' Income
 - F. Net Margins as Income
 - G. A Practicable Solution of the Problem
 - H. The "Pricing-Out" Question

6. The Tax Privilege Accorded Co-operatives
is Inequitable and Uneconomic, and It
Deprives the Government of Needed
Revenue
 - A. The Privilege is Inequitable
 - B. The Privilege is Uneconomic
 - C. The Privilege Deprives the
Government of Needed Revenue
7. The Co-operatives' Tax Advantage Promotes
the Development of a Co-operative State
8. The Place of Co-operatives in a Free-
Enterprise System
9. Conclusions
10. Recommendations.

All of which is respectfully submitted

Robert T. Patterson

2. BROADER ASPECTS OF TAXATION

2-A. Preliminary Considerations

2.1 Although this Submission deals primarily with the privileged tax treatment, under the Income Tax Act, of one particular kind of corporation, namely, the co-operative business association, it seems advisable at the outset to indicate the framework within which that type of corporate business is largely tax exempt. However, doing so does not require a survey of the Canadian tax system, nor need it involve a discussion of fiscal and monetary policies and the various theories of Government finance that those policies at various times have reflected.

2.2 To avoid confusion, and to clear the way for the analysis developed throughout this Submission, we shall assume that the Federal Government, over a reasonable period of time, intends to balance expenditures with revenues and that the banking system pursues money-credit policies that are essentially sound, that is, non-inflationary. Let us postulate also that a high rate of economic growth and the increasingly higher standard of living that it would provide are desirable goals, and that any measures consonant with freedom that are within the purview of the Government (including suitable revision of the tax laws) and that would lead to these goals are likewise desirable. Suffice it to say here that a reasonably high rate of economic growth would go far toward solving the problem of unemployment.

2.3 If a tax system is highly complex, as the present system is, there are likely to be large inequities and substantial diseconomies resulting from certain of the taxes. Perhaps in the shorter run the most that can

be hoped for under the circumstances in which Government expenditures make necessary a variety of taxes and high rates, is a policy committed to the reduction of those inequities and diseconomies. But the sound longer-run goals of fiscal reform are surely a system of taxation that takes the taxpayers' dollars from him as fairly as possible and with a minimum of economic loss (whether apparent or concealed) to the national economy, and the establishment of a level and direction of expenditures that will use those dollars as fairly and as effectively as possible, with a maximum of economic benefit to the Nation at large.

2.4 Because the Commission is primarily concerned with taxation, it probably has to assume a continuing high level of Governmental expenditure, but this does not prevent it from recognizing that its task of determining what may be the best possible system of taxation would be simpler and the results more definite if the Government's expenditures were substantially reduced.

2.5 Two generally accepted principles of taxation can serve as guides toward the solution of tax problems generally as well as the solution of the particular tax problem with which the subsequent sections of this Submission deal. The first of these principles is that of equity. It prescribes equal treatment for tax subjects (individuals or firms) that are in essentially equal or like circumstances, and it permits a differentiation in tax treatment only in so far as there is a relevant difference in the circumstances of the subjects taxed. Although equitable taxation requires justice and impartiality, and so is ethically

or morally right, it can be shown also to be more economical for the society as a whole than inequitable taxation.

2.6 The second principle is that of economy. In so far as possible, taxation should be economically neutral. That is, it should not prevent the optimum allocation and use of the Nation's resources that a free-market economy makes possible.¹ It can be said categorically that taxation that limits the production of desirable goods and services or that interferes with free, competitive marketing processes is uneconomical.

2.7 These two basic principles provide standards for judging the quality of a tax system and each particular kind of tax within it.² We shall apply them to the income tax especially as it is levied on corporation earnings with extreme partiality toward certain types of business corporations and with consequent harm to the corporations that are not so favored.³

2-B. Economic Effects of the Personal Income Tax

2.8 The personal income tax claims our attention only in passing, as it is not a major consideration in the study that follows. It is fundamentally different from the

-
- 1 When there is monopoly not otherwise subject to Government policy the gains attributable to the monopoly advantage should be taxed away.
 - 2 Other principles of taxation, such as those of convenience, certainty, economy in administration and compliance, and fiscal adequacy also are important, of course.
 - 3 The primary objective of The Equitable Income Tax Foundation, as set forth in its Bylaws, is "To encourage study, research and investigation on the subject of taxation and its effect on the economy of Canada, and, in particular, to study the adverse effects of inequitable taxation on the economic growth of Canada."

corporation income tax because it falls directly on individuals, whereas the corporation income tax falls first upon business entities and through them upon individuals, some in their role as stockholders, others perhaps as employees and suppliers of corporations, and the many who buy the corporations' products. Apparently the personal income tax is not so much subject to shifting as is the corporation income tax, which according to students of the subject, is to a large extent shifted from the corporations to their customers through higher prices.

2.9 Although the present personal income tax has adverse effects upon the incentives of individuals to work and the ability of individuals to invest, much of these effects appears to stem from the highly progressive rates and the extremely high rates in the top brackets (which, incidentally, yield very little revenue). If the rates and other provisions of the personal income tax were equitable and were such that the tax could be administered so as to minimize evasion, it would be as good a tax as any, and better than most.

2-C. Economic Effects of the Corporation Income Tax

2.10 The corporation income tax, on the other hand, cannot be called a good tax. Even if its application were entirely equitable, it would be a bad tax, because it tends generally to reduce saving and discourage investment and business initiative, thereby restricting economic growth.

2.11 Nevertheless, until recent years few economists have dealt harshly with this tax, possibly because the majority, who are of the so-called "liberal"

persuasion, have regarded it as a tax on "profits"¹ and as thereby a means for redistributing income. Such economists have favored it also as a politically feasible way of obtaining large revenue and as a flexible, automatically adjusting element that furthers compensatory fiscal policy. Yet at the high rates that have prevailed for many years the corporation income tax is as economically stultifying a tax as has ever been levied in Canada and the United States.

2.12 It is widely recognized that the corporation income tax has an adverse effect on investment, both through the resulting reduction in funds available for financing expansion and through the reduction in the incentive of corporation managements to undertake the expansion of their businesses. The tax also has the effect of distorting methods of obtaining business capital, inordinate preference often being given to borrowing (with its attendant financial hazards) rather than to the acquisition of more equity capital. Moreover, the tax makes it difficult for new and rapidly growing corporate businesses to obtain as much capital as they can use effectively. Because such corporations often are leaders of their industries in the development of new products and new techniques, the financial restraint upon them due to the tax serves as a partial protection for older, entrenched businesses against the full vigor of their competition. Thus progress is

1 Until fairly recent times the usual view among economists was that the corporation income tax could not be shifted. Now, more realistically, the fact is being recognized, even by "liberal" economists, that to a large extent the tax is passed on to consumers. This change in economic thinking will in due time undoubtedly cause legislators to look upon this tax with greater skepticism.

slowed, and the Nation is prevented from obtaining the full benefits (in terms of more goods at lower costs and lower prices) that a thoroughly dynamic, competitive economy would provide.

2.13 The greatest harm done by the corporation income tax comes about through its adverse effect upon the incentives of corporation management to add new productive facilities and in other ways to expand operations. When contemplating the investment of funds in the expansion of its business, corporation management must have the prospect of an after-tax return on its investment sufficient to offset both the interest cost of the capital committed to the investment and the possibility of loss that is involved.

2.14 To illustrate the problem that management faces, let us assume that a 10 per cent annual after-tax return is considered necessary if the additional investment is to be just barely attractive. Then, for a corporation subject to a 50 per cent tax rate, the expected pre-tax return on the investment will have to be at least 20 per cent, because the income tax will cut this return in half.

2.15 A brief but excellent analysis of the adverse effect of the corporation income tax on business expansion and economic progress was made by Mr. George Terborgh, a well-known American economist, in the following statement:¹

1 "Corporate Income Tax Rates", Tax Revision Compendium, Compendium of Papers on Broadening the Tax Base, submitted to the Committee on Ways and Means in connection with the Panel Discussions on the same subject to be conducted by the Committee on Ways and Means, beginning November 16, 1959, Vol. 3, p. 2303 ff.

"The increase in the required pre-tax return automatically excludes a whole range of investment projects that would be eligible in the absence of the tax, or at a lower tax rate. It limits eligibility, in other words, to projects of great urgency. The result is the deferment of both new business ventures and investments in the improvement of existing operations until their expected pre-tax return rises to the high requirement. . . . Old facilities must become more decrepit and inefficient before they are replaceable. Their service lives are extended. The economy drags along in consequence with a productive mechanism of greater average age, and with more accumulated deterioration and obsolescence than would obtain in the absence of the tax. By the same token - and here is the point of issue - this shielding of existing capacity from new competition permits the sale of its products at higher rates than could otherwise be obtained. It is through these higher prices that the income tax is shifted to the market.

.

"I conclude that there is no foundation to the common belief that a shifted corporate income tax is harmless.

.

"In short, it reduces the effectiveness of competition and slows economic progress."

2.16 Without qualifying our conclusion that the corporation income tax is uneconomic, we must acknowledge that it would be unrealistic to suggest elimination of the tax in its entirety at once. The \$1.2 billion obtained by means of this tax is so large a contribution to national revenue that an attempt to find alternative sources for the whole amount within a short period of time would be difficult and disruptive, and almost certainly it would not be politically feasible. Although a transfer of a part of the burden of the corporation income tax in the short term, and the transfer of a progressively larger part of it in the longer term, is highly desirable, it is only realistic to assume that at least at a reduced level this tax will continue to be a source of considerable revenue for some time to come.

2.17 In this circumstance, when because of the exigencies of revenue requirements a tax that is widely admitted to be unsatisfactory and to have a retarding effect on the economy has to be retained, it is essential that its impact should be distributed as fairly as possible. If the manner in which the tax is imposed is unfair this only serves to enlarge the economic distortions caused by the nature of the tax itself.

2-D. Some Generalizations

2.18 Before proceeding from this broad appraisal of the corporation income tax to the analysis of a particular way in which its discriminatory application distorts and harms the national economy, a few generalizations may be in order.

2.19 Competitive business generally, whether corporate or otherwise, needs all the help and encouragement that permissive, non-restrictive Governmental

policies and attitudes can provide. We should never let those who enact our tax laws forget that through business activity most of the Nation's wealth is created. It is ironical that well-meaning legislators have been so blind to the effects of taxes that reduce initiative, discourage investment, hamper business activity, and restrict economic growth.

2.20 Not only businessmen but many other thinking people who feel concern for the economic welfare of the country are looking to this Commission to help free the Nation from the thrall of out-dated and disproved fiscal dogma and guide it toward the establishment of the best possible tax system.

A new and bold approach to Canada's tax problems, implemented by appropriate legislation in a climate generally favorable to competitive business activity, could make Canada, on a per capita basis, perhaps the richest nation of the world. The Commission's task involves both practical economic considerations and high moral judgments.

3. THE PROBLEM OF CO-OPERATIVE TAX PRIVILEGE AND ITS SETTING

3.1 Co-operatives, although they are corporations, are to a large extent exempted from the corporation income tax. Section 73 of the Income Tax Act gives newly-established co-operatives complete exemption from the tax for the first three years of operation. Section 75 of the Act permits co-operatives (and other corporations), subject to certain restrictions, to deduct from their income patronage dividends paid to customers. Complete elimination of income from taxation through the payment of patronage dividends is prevented in most cases by the provision that such payment may not reduce taxable income below an amount equivalent to 3 per cent of the capital employed in the business, which is calculated according to the special and somewhat artificial criteria established in the first schedule to the Excess Profits Tax Act. Capital employed for purposes of this section includes any monies borrowed from other than banks and credit unions. However, the minimum earnings of 3 per cent of capital employed may be reduced by the interest paid upon borrowed funds included in capital.

3.2 Ordinary investor-owned corporations can make little or no use of the privilege of deducting patronage dividends from their income; but co-operatives, because the payment or allocation of patronage dividends is an essential part of their owner-member relationship, can and do take full advantage of it, thereby greatly reducing the amount of their income that is subject to tax.

3.3 Moreover, the co-operatives need not pay their patronage dividends in cash in order to reduce

their tax liability. They may simply allocate their income to their members by crediting them in one way or another without necessarily making a firm and definite commitment to pay cash at some future time. In thus retaining a large part of their earnings largely tax-free, the co-operatives have enjoyed an important source of capital funds that have greatly aided their growth and expansion.

3.4 The tax status of ordinary investor-owned corporations is in marked contrast to that of the co-operatives. The ordinary corporations are subject to a tax of 21 per cent on the first \$35,000 of their income and 50 to 52 per cent on income in excess of \$35,000.

3.5 The "3% of capital employed" provision has ensured that most co-operatives have made some contributions in income tax. However, the definition of "capital employed", used in the Act, has the effect of understating the real asset worth of a business and as a result the provision has apparently been much less productive of tax than its authors might have expected. It is understood for instance, that the Alberta Wheat Pool with net earnings in one year of over \$3 million paid tax at a rate of under 4 per cent of its earnings. The competitor of such a co-operative would have paid tax at around 50 per cent. The extent of the discrimination needs no emphasis. If a co-operative and an ordinary corporation both employed \$1 million of capital, none of which was borrowed, and each had an income of \$60,000, the co-operative would be taxed only on \$30,000 while the ordinary corporation would be taxed at the progressive rates applicable to the full \$60,000.

As a further extension of the example, if each company had income of \$60,000 and total capital of \$2 million, \$1 million consisting of funds borrowed at 6 per cent interest from lenders other than banks or credit unions, and \$1 million derived from other sources (shares, etc.) the co-operative could eliminate its income entirely, while the company, if it did not pay patronage dividends, would be taxed on the full \$60,000. In this case the \$60,000 of interest the co-operative paid on borrowed funds would totally offset the 3 per cent of capital employed and there would be no restriction on the proportion of the co-operative's profits it distributed by way of patronage dividend.

3.6 It should be made clear that co-operatives, in taking full advantage of the provisions that favor them in the Income Tax Act, are not evading taxation, in the sense that they are improperly benefitting themselves. Their avoidance of a large part of the tax burden that ordinary corporations cannot avoid is the fault of the tax law. Co-operative management is duty bound to the co-operatives' members to make the most of the advantage that the law provides. It is the duty of the legislators to see that tax laws are equitable.

3.7 It should be noted also that whatever objection is made in this Submission to the co-operatives' tax privilege is not an objection to the co-operatives themselves. Co-operatives have just as rightful a place in the free-enterprise system as ordinary corporations, partnerships, and individual proprietorships.

3.8 Because this Submission deals with the

discriminatory application of what is by far the most important tax levied on business by the Federal Government, in both Canada and the United States, we have called attention in the preceding section to the general proposition that the taxation of business tends generally to discourage enterprise and investment, hamper productivity, and restrict economic growth. Although a reduction in the corporation income tax would reduce the advantage now enjoyed by the tax-favored co-operatives, and the elimination of that tax would remove the co-operatives' present tax advantage, the solution of this problem of tax inequality should not wait upon this doubly desirable major reform of the tax system, if such reform is to be delayed. In the meantime some other solution must be sought.

3.9 Although much of the analysis that follows in this Submission is factual statement, the use of statistics has been kept to a minimum. Moreover, only limited reference is made to the history of the co-operative movement, the co-operative form of organization, the ways in which the co-operatives transact business and reward their patron-members, and the evolution of the co-operatives' competitive advantage as that has come about through favored treatment by Government. These and similar matters undoubtedly have come to the attention of the Commission already.

3.10 The intention here is to deal primarily with the larger issues that are involved in the co-operatives' present tax status, examining them not from the point of view of any one industry but from that of the whole economy. The principal question

to be answered is whether it is in the public interest to give more favorable tax treatment to co-operatives than to ordinary corporations.

3.11 The co-operative tax problem in the United States is similar to that problem in Canada. In both countries the crux of the problem is the privilege accorded co-operatives of deducting patronage dividend payments and allocations from income before computing the tax liability.

3.12 In 1962, in the United States, a step was taken toward tax equality when Congress enacted legislation providing for a tax on the income of farmer co-operatives, to be paid either by the co-operative or by its patron-members. To escape tax, a co-operative must pay 20 per cent of its patronage dividend in cash. A patron-member receiving the cash dividend must pay tax on it to the Federal Treasury, if he has sufficient income to subject him to tax. This has reduced somewhat the ability of the co-operatives to accumulate capital tax free. In Canada, the problem is somewhat modified by the provision that patronage dividend payments may not reduce taxable income to less than 3 per cent of capital employed, although the somewhat artificial manner of determining capital employed (as noted above) may substantially lessen the amount of taxable income that the percentage figure seems to suggest.

3.13 These modifications, however, are far from solving the problem, in the two countries. The establishment of your Commission, and the Commission's careful study of the problem give hope that at last the problem will be dealt with realistically in Canada, thereby setting an example that various members of the U.S. Congress can point to when they again make their case for equality in the tax treatment of co-operatives and ordinary corporations.

4. HOW SPOKESMEN FOR THE CO-OPERATIVES HAVE SOUGHT TO JUSTIFY THE TAX ADVANTAGE

4.1 Leaders of the co-operative movement have endeavored to justify the tax-favored status of co-operatives in various ways. Their oldest and simplest argument has been that because co-operatives are an "infant form of business organization" they should be protected and fostered by the Government, through tax exemption and in other ways. This argument avoids the real issue, which simply stated, is whether or not co-operatives have income that can be properly subject to taxation. That issue has long been obscured both by confusing terminology and by extremely different assumptions as to the nature of the co-operative and its functions as a business entity. In effect, the opponents and the proponents of the tax advantage for the co-operatives use two different terminologies, one of them consisting of the ordinary expressions of the business and financial world, the other consisting of words and phrases devised to fit the various theories advanced in support of the co-operatives' claim to exemption from the income tax. Those theories are essentially attempts to justify the deduction or exclusion of patronage dividends from earnings that otherwise would be largely subject to taxation.

4.A The "Infant Form of Business Organization" Argument

4.2 The nature and scope of co-operatives' business transactions are today far different from what they were when the typical co-operative was small, localized, and limited to carrying on one or a few business activities for a comparatively few members. Co-operatives once were looked upon as being somewhat in

the nature of charitable institutions, and some were so small and so limited in their transactions that they were in actuality little more than agents for their member-patrons. For many years they were considered a means for aiding the impoverished and the "downtrodden working class" in England and other European countries. The early history of the consumer co-operative movement has a heart-warming quality. One reads of how in 1844 the 28 Rochdale Pioneers, having accumulated by dint of hard thrift, a tiny capital, rented part of an old warehouse in Toad Lane where they sold to themselves flour, oatmeal, butter, and sugar at near wholesale prices. From the beginning of the co-operative movement the democratic nature of the simple co-operative enlisted the sympathetic interest of students of economic life.

4.3 For these reasons there was a presumption that what was the smallest and apparently weakest, yet equally meritorious, of the various forms of business organization should be protected and fostered. Even today many people tend to look upon co-operatives as semi-benevolent organizations, although in actuality the co-operatives serve an enlightened, often well-off, tax-wise cross-section of the population. Moreover, the officers of the larger co-operatives are "big businessmen" in the same way that the officers of the larger ordinary corporations are. Their interest, while serving well their organizations, is to do well for themselves also, in terms of pay and promotions. The co-operatives' tax privilege is a great advantage for them as well as for their organizations. Co-operatives not only employ efficient management but they also quite properly engage highly qualified lawyers, chartered accountants and economists to protect and promote their income tax advantages. In short co-operatives carry on their businesses in accord with keen business acumen.

4.4 The co-operatives have "grown up". They are no longer an "infant" form of business organization. The trend of co-operative business has been markedly upward. In Canada the volume of co-operatives' business increased from \$235 million in 1940 to \$1,335 million in 1960.¹ In the United States during this same period the increase was from \$2 billion to \$12 billion.² Although this was a period in which the value of farm products and the amount of farm income increased, it seems evident that a considerable part of the growth in the co-operatives' business was due to competitive advantage through the leverage of their tax-favored status.

4.5 Co-operatives have ceased to be merely small neighborhood groups. They have become an important part of the Nation's economic life. Many are large firms, with far flung business operations. They manufacture, wholesale, and retail thousands of products; they provide banking and insurance; they market grain and livestock; they are in process of operating a packing plant; they grind feed, process vegetable oils, market and process poultry and dairy products, pack fruit, operate lumber mills, own and rent out space in office buildings; they engage in the milling and marketing of flour; they engage in printing and publishing and petroleum operations in all phases from owning oil wells to the selling of the finished products at service stations; they buy, sell and process seeds, sell chemicals and fertilizers, coal, farm supplies, machinery and binder twine. The long continued expansion of markets for their products and services has been paralleled by integration of the various phases of productive activity, from the extraction of raw materials,

1 Data include sales of farm products and sales of supplies at retail to co-operatives' members.

2 Data are for farmer marketing and supply co-operatives only.

1.1. The co-operatives have "grown up". They are no longer an "infant" form of business organization. The trend of co-operative business has been steadily up-

ward. In Canada the volume of co-operative business increased from \$232 million in 1940 to \$1,332 million in 1950.¹ In the United States during this same period the increase was from \$2 billion to \$15 billion.² Although this was a period in which the value of farm products and the amount of farm income increased, it seems evident that a considerable part of the growth in the co-operative business was due to competitive advantage through the leverage of their co-operative status.

1.2. Co-operatives have tended to be mainly small neighborhood groups. They have become an important part of the national economic life. They are large firms, with the same business characteristics. They manufacture, store, wholesale, and retail thousands of products; they provide banking and insurance; they market grain and livestock; they are in process of operating a packing plant; they market feed, process vegetable oils, market and process poultry and dairy products, make bread, operate laundries, etc. and rent out space to other enterprises; they engage in the selling and marketing of their own products in marketing and distribution and petroleum operations in all phases from owning oil wells to the selling of the finished products at service stations; they buy, sell and process meat, milk, chemicals and fertilizers, coal, farm supplies, machinery and other things. The long continued expansion of services for their products and services has been paralleled by integration of the various phases of productive activity, from the extraction of raw materials,

¹ This includes sales of farm products and sales of supplies to co-operative members.
² Data are for farmer marketing and supply co-operatives only.

through processing, manufacturing, transportation, financing, wholesaling, and retailing.

4.6 The assertion sometimes made that the co-operatives are wholly dependent on tax-free retained earnings to finance their growth is not valid. They can sell securities to their members; they can borrow funds from the investing public; and their bank credit is just as good as that of comparable proprietary corporations, even better perhaps, because of their tax advantage.

4.7 The argument that co-operatives as an "infant" form of business organization deserve special, favorable tax treatment has lost whatever validity it may have had.

4.B Semantic Confusion: Synthetic Words and Phrases and the Specialized Use of the Term "Co-operative"

4.8 The double terminology that pervades the thought and the literature on co-operatives has done much to bewilder the unprejudiced, inquiring layman. Spokesmen for the co-operatives insist, for example, on the terms "patronage refund" or "patronage rebate" rather than "patronage dividend" because those terms imply a price adjustment rather than a disbursement of earnings. They employ the term "net margin" rather than "income" or "earnings," because use of the latter terms would negate the assumption that co-operatives have no income. They prefer to speak of the disbursements that they make in proportion to patronage as being "excludable" rather than "deductible" from whatever gain has resulted from the co-operatives' transactions, for the term "deductible" may seem to imply that there has been an element of income through the co-operatives' operations.

4.9 The term "co-operative" is itself ambiguous. As one student of the subject has pointed out,

"The word 'co-operative' suffers from having two meanings. In one sense it is as vague as 'working together,' or even, in modern usage, 'ready to help.' In the other it is the precise, in many countries the legal, definition of a particular kind of business organization."¹

4.10 Some writers, in discussing the co-operatives, dwell upon the general nature of human co-operation in many areas of life, intending to show the extension of a common tendency to one particular form of business organization. This view confuses the formal, organizational nature of the owner-patron co-operative business association with such sporadic occurrences - partly sociable in their nature - as barn-raising, logrolling, quilting parties, and husking bees, as well as other expressions of neighborly aid of a quid pro quo sort.

4.11 One need hardly comment that co-operation has always occurred among people in most phases of their living, that it is not solely economic, and that where it finds formal organization it is not necessarily based upon an identity of ownership and patronage. In our society the family is the primary co-operative unit, but church, lodge, school, professional association, and the like, are also, in their ways, co-operatives.

4.12 The term "co-operative," although convenient and expressive when applied to a business organization, is used arbitrarily. Few would claim that co-operation can be found only in those firms that are

1 Margaret Digby, The World Co-operative Movement (London: Hutchinson's University Library, 1948), p.7.

formally designated as "co-operatives." In fact, every form of business involves co-operation for mutual advantage. The stockholders in an ordinary corporation have joined together to effect the production of goods and services, thereby to obtain a reward for their efforts and capital. The individual proprietor of a business enlists the co-operation of employees, suppliers, and lenders in his effort to meet the wants of others and gain a return for himself.

4.13 Employment of the term "co-operative" as though it were applicable only to the activities of a particular kind of business association is, of course, merely a matter of word usage. The pre-emption of the word in this way should not obscure the fact that our highly efficient industrialized economy has become what it is - in terms of productive power and wealth - through a minute division of labor, elaborate specialization, and the cohering force of a voluntary association of co-operating agents of production, regardless of the business form.

4.C Four Theories of Exclusion¹

4.14 Four principal theories are offered by spokesmen of the co-operatives to justify the exclusion or deduction from gross income of the amounts paid out by co-operatives as patronage dividends. They may be conveniently referred to as the "partnership" theory, the "price-adjustment" theory, the "agency" theory, and the "debt-payment" theory.

4.15 The Partnership Theory holds that since

1 In discussing the price-adjustment theory and the agency theory I have relied heavily on the excellent work of Roswell Magill and Allen H. Merrill, "The Taxable Income of Co-operatives," Michigan Law Review, XLIX (December 1950).

a co-operative association is simply a group of member-patrons acting in concert it is, like a partnership, "merely the alter ego of its patrons". Therefore, it is argued, the co-operative itself cannot have earnings, and whatever income it obtains is in reality the income of its patrons.

4.16 This is the weakest of the theories, because co-operative associations are formally incorporated entities - they are corporations; and the argument does not presume also that stockholders in ordinary corporations are, nevertheless, partners in those organizations. Co-operatives own property, enter into contracts, incur debt, and transact business in their own names. They are chartered in perpetuity as are ordinary corporations; and their members, like ordinary stockholders, have limited liability. In the United States, Congress made plain that it regarded them as corporations when it specifically exempted certain farmer co-operatives from the corporation income tax; and in the Wisconsin Co-operative Milk Pool Case¹ the Court of Appeals held that

"... such corporations differ from others not in corporate function but only in that the profits, instead of being distributed to stockholders, are allocated to patrons ratably in proportion to the amount of business transacted with the latter."

It seems clear that if a co-operative is a corporation it is not a partnership.

4.17 The Price-Adjustment Theory has been the

1 119 F. (nd) 999 (7th Cir. 1941)

a co-operative association is similar to a group of persons
 persons acting in concert in the same manner, namely,
 the effecting of the common purpose, it is argued,
 the co-operative itself cannot have a purpose, and there-
 fore income is obtained in its dealing with the members of the
 association.

1.15 This is the nature of the theory, but
 some co-operative associations are formally incorporated
 entities - they are corporations, and the members are
 not persons but legal entities in relation to corporations.
 They, nevertheless, function in the same manner as
 co-operatives and persons, and have legal rights, income, debt,
 and property. They are, however, in legal terms, they are
 considered in property as one entity, corporation;
 and their members, like ordinary shareholders, have
 limited liability. In the United States, however,
 some claim that it is regarded that as corporations, they
 are specifically exempted under certain Federal regulations
 from the corporation laws that are in the business
 co-operative bill (see also the House of Representatives
 report).

"... each corporation differs from others
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1.17 The fundamental theory is that the

most influential one in the co-operatives' attempts to justify their tax-favored situation. Briefly, it asserts that a co-operative transacts its business at cost and that its patronage dividends are simply an adjustment in the prices of the products it sells to or buys from members. Proponents of the theory hold that such payments, being in the nature of price rebates, cannot be considered income. The underlying assumption is that the co-operative has a contractual obligation to distribute its earnings or net margins to the members as patronage dividends. When the distribution is in some form other than cash it is supposed to constitute an "immediate re-investment" on the part of the patron-members.

4.18 The basic question with respect to the taxability of co-operatives' net margins, as Magill and Merrill point out, is:

"Can a corporation buy products or raw materials from its equitable owners at prices substantially greater than their market value or substantially greater than the prices at which they are otherwise obtainable; or sell other products to its equitable owners at prices substantially less than market and, thus, by purporting to do business 'at cost', avoid earning taxable income?"¹

4.19 Similar tax problems have arisen where two parties have related economic objectives but are not dealing at arm's length:

"The firmly established rule in resolving

1 Magill and Merrill, p. 187.

such problems.... is that in transactions between related taxpayers, where there is an element of self-dealing, economic income cannot be effectively allocated by the parties so as to mitigate the total tax burden.... Moreover, payments labelled as 'selling prices' by buyer and seller are an accurate measure of the costs of doing business only so long as buyer and seller have adverse economic interests and are trading at arm's length."¹

4.20 The Price-Adjustment Theory fails to take account of the fact that co-operatives are, in actuality, separate as business entities from their patrons; that there is an owner relationship as well as the patron relationship between co-operatives and their members; and that the transactions of successful co-operatives with outsiders result in a gain or profit to the members. "The net margin or the patronage dividend is all or some part of that profit, and it is being distributed or allocated to the members as the true owners of the business."²

4.21 Although it may be argued that a part of some patronage dividends is not similar to the dividends of ordinary corporations (because of prices set arbitrarily to members), there is no clear-cut difference between patronage dividends in general and the dividends of proprietary corporations. The fact that patronage dividends are paid to patrons, who are also stockholders, does not make such dividends anything

1 Magill and Merrill, p. 188.

2 Ibid., p. 189

other than a distribution of profits. They are paid to individuals whose interests the co-operative is seeking to further. It is not dealing with those persons in a situation where there are adverse interests. Co-operatives are organized to increase the gain of their members, and to the extent they do so they have profits.

4.22 A rebate is actually such only if paid to a person whose interest is adverse to that of the business which pays it. The gain of a marketing co-operative arises primarily from transactions with those to whom it sells the products of its members; the gain of a purchasing co-operative arises primarily from its dealing with those from whom it purchases. But the patronage dividend is not paid as a rebate to the person or firm from which the gain is derived. In an analysis of the taxability of co-operatives' earnings the significance of this point cannot be over-emphasized.

4.23 Ordinarily, the profit of a co-operative is transferred to its owner-patrons either through prices more favorable than those prevailing in the market, or through patronage dividend payments and credits, or through a combination of these. What is termed a "price-adjustment" or a "rebate" is ordinarily a distribution of profit. It seems obvious that the members of a co-operative have not made that profit just by dealing with themselves.

4.24 The Agency Theory holds that the co-operative is merely the agent of its patrons and that when there is an excess of funds after it has paid expenses as bailee for the patrons it is legally obliged to distribute that remainder to them. It acts, supposedly, simply as a trustee when it takes legal title to their

products in order to facilitate sales.

4.25 More observation, however, shows that co-operatives, as we know them today, are not true agents of their members. In their operations they take title, ordinarily, to the products that they purchase from or sell to their members. Moreover, an organization that pays dividends and accumulates reserves, as a co-operative ordinarily does, can hardly be regarded as a mere legal agent of its owner-patrons. If a marketing co-operative were to sell the product of each particular member and then account to each for the gain or loss on his specific sale the fact of agency might be established. Or, in the case of a purchasing co-operative, if each patron were to determine where, to what extent, from whom, and upon what terms the goods he wanted were to be obtained there could be agency.¹ The fact is that the patronage dividend paid to any one member is not dependent upon his individual transactions with the co-operative but upon all its dealings throughout the year. "The member is a joint venturer in a corporate business, as is a stockholder in a business corporation."²

4.26 The manner in which co-operatives are controlled shows that they are not mere agents:

"The control of a co-operative corporation by its members resembles much more closely the control of a corporation by its stockholders, than the control of a common law agent by his principal. The discretion vested in the management of the co-operative

1 Magill and Merrill, pp. 184-185

2 Ibid., p. 186

"is substantially equivalent to the discretion vested in and exercised by the management of any corporation, or by the management of an association taxable as a corporation. Methods of operation, expansion of business activities and the accumulation or distribution of earnings are matters controlled by members only through their directors, who exercise a discretion far removed from the limited authority of a common law agent."¹

4.27 What appears to be a new theory of exclusion is the Debt-Payment Theory. According to it, if a patronage contract between the co-operators and the co-operative is properly drawn it will "constitute a pre-existing obligation to pay the patronage payments."² According to one of its proponents -

"... if and to the extent that a co-operative association (or any other taxpayer) receives money subject to a then existing and legally enforceable obligation to pay over such money to its patrons, that money constitutes a debt which the taxpayer owes to its patrons (rather than income to the taxpayer) and, being a debt rather than income, it properly is excludable from the taxpayer's gross income."³

1 Magill and Merrill, pp. 185-186

2 Charles E. Nieman, "The Proper Treatment of Co-operatives," in Tax Revision Compendium: Compendium of Papers on Broadening the Tax Base, submitted to the Committee on Ways and Means in connection with the panel discussions on the same subject to be conducted by the Committee on Ways and Means beginning November 16, 1959, Vol. 3 pp. 1967-1981.

3 Ibid., pp. 1971-1972.

4.28 This theory resembles the price-adjustment theory, with emphasis, however, upon the purported indebtedness that is involved. Actually, the theory is irrelevant; the real question is: What entity earned the money that is used to pay the debt? It is an established tax principle that the entity earning the income cannot escape the tax due thereon by contracting the income away. The existence of a formal contract would not justify ignoring the real income of a corporation. An anticipatory assignment of income does not offset tax liability.

4.29 If the debt-payment theory had any merit, any business corporation could adopt a by-law requiring it to pay its usual dividends to its stockholders. Then, when it paid those dividends, it would be just paying off debts. But how would that change the fact that the income used to pay off the debts were taxable income?

5. THE CONTROLLING FACT: CO-OPERATIVES HAVE THE SAME
KIND OF INCOME AS THAT OF BUSINESS CORPORATIONS
WHICH ARE FULLY SUBJECT TO THE INCOME TAX

5.A The Nature of Business Income

5.1 The primary function of any business is the creation or augmentation of wealth. Whatever is done through combinations and arrangements of factors of production, all along the route from extraction of raw materials to sale of finished products, including marketing activities, adds to the value of the products. Few if any economists would assert that the stages of the marketing process that are necessary to bring goods to their ultimate users are not a part of the whole productive process or that value is not added to the goods that pass through them. In every business, whether it deals in goods or services, this function of creating and adding value is practically continuous. When a business is reasonably well operated there is an excess of receipts over expenditures. This excess, to put the matter very simply, is what constitutes income or earnings. Under competitive conditions it is the reward to owners of the business for the use and risk of their capital. For clarification of this basic concept we must distinguish between the income or earnings of business and what properly may be called profit.

5.2 The layman's conception of profit, as well as that of the accountant, the tax collector, the financial reporter, the labor leader, and the sociologist, is quite different from that of the economist. They use the term generally to include normal earnings on equity capital as well as excess gains.

5.3 To the economist, however, profit is whatever residue there may be after all payments have been

2. THE ECONOMIC FACTS: COLLECTIVELY HAVE THE SAME
 KIND OF EFFECT AS THAT OF ECONOMIC ORGANIZATIONS
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2.4 The Nature of Business Income

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 as that of the government, the tax collector, the financial
 reporter, the labor leader, and the sociologist, is quite
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 generally in the sense of normal earnings or equity earned as
 well as business profit.

2.4.3 In the economic theory, profit is what
 even realize others may be either all payments have been

made, including wages and salaries, rent, and interest (implicit and explicit). Various terms are used to distinguish the economist's conception of profit from that more loosely held: "pure profit," "economic profit," "excess profit". Such profit occurs when a business obtains for its products more than the sum of all its costs, including payment to management for what that management is worth and payment of a return on its capital at the rate that its stockholders could obtain on the next best investment available to them. The part of a subsidy that a business may receive over and above its costs is also in the nature of pure profit.

5.4 In a dynamic economy profits occur, but there are losses too. The imperfectly competitive free-enterprise system that we know today, of which the co-operatives are a part, is not so much a profit system as a profit-and-loss system. Even in prosperous times, much of the profits in some parts of the economy are offset by losses in other parts; and the net gains of business during the prosperity phase of the business cycle are to a considerable extent offset by losses during recession and depression.

5.5 Where there is strong competition within an industry and firms are free to enter that industry at will, pure profits cannot last long; they are competed away, and earnings of all but the weakest firms tend to be only enough to cover all costs of operation. What seem to be excess earnings of some firms are ascribable either to superior management or to fortunate circumstances. They are properly due either to the management for the additional value its skill has created or to those who assumed the financial risks of

the business.

5.6 Many laymen are unaware of the evanescent nature of the rather meager real profits that the free-enterprise, profit-making system yields over the course of time. This is because they look upon the ordinary, normal return on investment, as well as the extraordinary gains as profit.

5.7 Much the same view is reflected in the Income Tax Act. It is not concerned merely with profits as described here. It elaborately and arbitrarily defines for tax purposes what the legislators consider to be the income or earnings of corporate business. Most of the income of firms that are subject to the corporation income tax is a normal return on invested capital and compensation for risks assumed. It is not, for the most part, real profit at all. The fact to be emphasized is that the corporation income tax is not primarily a tax on profit, although it catches profit when that is a part of corporate earnings.

5.B. How Co-operatives Obtain Income

5.8 A reasonably well-run co-operative, because it is a productive, wealth-creating business, will have income. The particular way in which the owner-patrons participate in that income does not change either the fact of its existence or the fact that it has come about through the same kinds of value creating and bargaining as has the taxable income of ordinary corporations.

5.9 When a co-operative association is formed, that particular kind of business organization has been chosen because its prospective owner-patrons believe it to be the best means for benefitting themselves. They are not undertaking through their associa-

tion merely to carry out transactions between or among themselves or between their individual selves and their associated selves; but rather, they have associated in order to transact business as advantageously as possible with individuals and firms outside their own organization. It is from these latter transactions, ordinarily, that the income (earnings, gain, profit, net margin, or whatever else the overage above costs may be called) of co-operatives is derived.

5.10 In such transactions, if there is not sufficient acumen on the part of a co-operative's management, or if market conditions are unfavorable, there will be loss instead of gain; and no amount of mere loyalty and good will on the part of the owner-patrons can change this. On the other hand, astute management or advantageous market conditions, or the two combined, may result in large income for a co-operative.

5.11 So far as a co-operative's owner-patrons are concerned, if its prices are more favorable to them than prices elsewhere, what they gain is offset by a corresponding reduction in the co-operative's income; if a co-operative's prices are less favorable, the disadvantage to the owner-patrons is offset by larger income (or smaller loss) for their co-operative than would otherwise have occurred. In other words, the owner-patrons collectively do not make a profit or sustain a loss because of their transactions with their collective selves. Between themselves and their association there is not the same "arm's-length" bargaining that there is between their association and all others with whom it deals. The usual source of a co-operative's gain is its transactions with outsiders whose interests

are adverse to those of the owner-patrons. Likewise, it is through transactions of this kind that most of the income of proprietary corporations is achieved.

5.C Capital as a Source of Co-operatives' Income

5.12 Payment to capital as a part of the cost of production is a necessary business expense for co-operatives as much as for other forms of business. Such expense has to be incurred if the capital is to be obtained, whether from the owners of business or lenders, because there is not enough capital to go around and it must be "rationed" at a price determined by supply and demand in the market place for funds. Permanent capital originates only through saving. Savings represent sacrifice and abstinence - the foregoing or delay of the enjoyment of whatever things the saver might have obtained for his surplus. For that reason savings are not ordinarily created as rapidly as an expanding economy can use them to add to its productive capacity. Because they are productive when invested but are formed at a sacrifice to the saver, and because they are scarce relative to the need for them, savings command a price, that is, a part of the product they help to create.

5.13 Both co-operatives and ordinary corporations use capital to produce goods and services; and through the transactions that take place they have earnings or income. In each case the income is fundamentally the same. The fact that much of the capital of the co-operatives has been obtained through involuntary "re-investment" of patronage dividends does not make the earnings of that capital unlike the earnings of capital in ordinary corporations. That the re-investment is involuntary is simply additional evidence that the co-opera-

tives are business entities separate from their members.

5.14 When a co-operative obtains capital from agencies subsidized by government on terms more favorable than those obtainable by another business entity with comparable credit in the ordinary capital market, it has a competitive advantage similar to that obtained through tax advantage. But when it borrows through the same financial channels that are available to other business, it pays a competitive rate, and to that extent its position is clearly competitive. If a co-operative relies upon its members to provide capital and does not pay them the full market rate, there is a concealed cost to members that may make the co-operative's operations seem more economical than they are in actuality. If, on the other hand, a co-operative pays its members more for the use of their capital than is necessary, its operations may seem to be less economical than they really are. In either case, the prices charged for its products or paid to its members for their products - whether above the market or below - must be taken into account.

5.D The Member-Patrons of a Co-operative are "Owner-Enterprisers of a Profit-Seeking Business"¹

5.15 The capital employed and the risks assumed in the conduct of a co-operative's business are those of the owner-patrons, who are just as much investors in a profit-motivated corporate business as are the shareholders in other business corporations. The owner-patrons are attempting through the transactions of their mutual organization to save or to gain. Though their

1 Lorne D. Cook, An Economic Analysis of the Federal Taxation of Income from Co-operative Enterprise (Doctoral dissertation, University of Michigan, 1954; typewritten, on microfilm), p.1.

savings may be hidden or obscured by the complex relationship of owner-patron, prices, and patronage dividends, those savings or earnings are there, nevertheless, to the extent that the association operates economically. It is in no true sense a "non-profit" association, for it has none of the typical characteristics of non-profit organizations. As Professor Cook has expressed it: "The gains from co-operative enterprise are found to be in the nature of corporation profits, which, although they are distributed according to patronage, accrue to member-patrons in proportion to investment and entrepreneurial risks undertaken."¹

5.16 All businesses, including co-operatives, that operate above the break-even point before equity capital is rewarded have earnings. It simply cannot be said that co-operatives, because of the nature of their organization, do not have earnings. As Albert W. Adcock has pointed out:

"When comparisons are made it is clear that co-operative corporations possess all of the essential attributes of ordinary business corporations except as to the basis of distribution of their net earnings The patronage dividends distributed by a co-operative corporation are in the usual case distributions of corporate income which only superficially resemble refunds or additional price payments."²

1 Ibid.

2. Albert W. Adcock, "Patronage Dividends: Income Distribution or Price Adjustment," Law and Contemporary Problems, XII (Summer, 1948), pp. 524-25.

5.17 The late Professor O. Glenn Saxon, of Yale University, showed the nature of co-operatives' business activities and earnings to be essentially the same as those of ordinary corporations:

"There is no basis in law, equity, economics, or logic for any co-operative corporation to deny that it absorbs risks, creates economic capital, income, and profits through the use of its own management, labor, and capital. If successful, it has both gross and net profits which are not its members' profits, and, if unsuccessful, has gross profits less than its operating costs, or net losses which are not its members' losses. Nor can it deny that it creates, in addition to profit and new wealth, new jobs, as does any ordinary corporation, unless it merely replaces other organizations. It, therefore, produces dollar income, economic income, and taxable income.

"The various absurdly illogical and inconsistent theories or claims of these co-operative corporations are, in the final analysis, only a deliberate or unconscious use of semantics for the purpose of confusing the real issues. The ownership of the income or profits of a co-operative corporation or any other legal entity turns not upon how that income or profit is distributed, but how it is produced and by whom it is produced."¹

1 U.S. Congress, House of Representatives, Committee on Ways and Means, Hearings, Revenue Revision of 1951, Part 2, 82d Cong., 1st Sess., 1951, p. 1350.

5.E The Problem of Determining Co-operatives' Income

5.18 It has been argued that patronage dividends should not be taxed, because it is impossible to determine to what extent they represent distributions of income and to what extent they do not. It is true, of course, that such dividends may understate or overstate a co-operative's earned income. In fact, a co-operative could operate in such a way that patronage dividends would not be necessary to affect a distribution of benefits to its patrons. Or a co-operative might pay patronage dividends that actually represented only savings due to the omission of such services to their patrons as free delivery, extension of credit, convenient location, and the like, the costs of which, had they been incurred, would be allowable deductions for the co-operative.

5.19 In some instances, marketing co-operatives set the prices paid to their members below prevailing market prices, and purchasing co-operatives set the prices charged their patrons above the market. This is done, ordinarily, to build up the organization's capital. In such cases, the resulting patronage dividends - which would be in excess of normal earnings - are not paid incash but are distributed in non-cash form as evidence of further investment of capital in the co-operative by its patrons. It must be noted, of course, that not all non-cash patronage dividends represent purely capital accumulation of this particular kind and therefore are not income. But considerations such as these have led some observers to question the suitability of patronage dividends as a basis for the application of an income tax in the case of co-opera-

tives.

5.20 For another reason the benefits of a co-operative to its patrons may not be indicated by the amount of its net margins or its patronage dividends. Co-operatives, if they choose to do so, can sell to their members at prices so close to costs, or buy from them at prices so close to what the co-operatives will realize, that little or no patronage dividend payments will result. The benefit to patrons would then appear immediately in prices, rather than later in patronage dividends. Such arrangements would substantially lower tax liability if co-operatives' earnings or net margins were subject to the income tax. Here we encounter the "pricing-out" question which is dealt with later in this section.

5.21 As we shall see, these aspects of the problem of determining co-operatives' taxable income do not make it insoluble.

5.F Net Margins as Income

5.22 In this connection it is convenient to refer to the farmer marketing and purchasing co-operatives in particular, although much of what is said is applicable to any co-operative association. The marketing co-operatives regard their patronage dividends as a re-adjustment in the prices paid to members for their produce; and the purchasing co-operatives look upon their patronage dividends as a rebate, a discount, or an adjustment of prices paid by their members. Although, in general, such dividends are not true rebates or price adjustments, it is necessary to examine more closely their nature and that of the net margins from which they derive.

5.23 In the case of the marketing co-operatives, payments may be made to members in cash or scrip, or both. Typically, both cash and scrip are given as the initial advance to the farmer whose product is to be marketed; additional payments may be made to him in these forms later during the marketing period; and finally, the gain or as yet undistributed return to the association is calculated and each member is paid his proportionate share, partly in cash and partly in some form or other of scrip. This general method of payment varies from one co-operative to another, but the payment to the producer partly in cash and partly in paper is the common procedure. The hazards of price fluctuation and the attendant possibility of overpayment in cash are thus avoided. Where it is the policy of the co-operative to build up its resources, that is made possible by somewhat more use of scrip than would otherwise be required.

5.24 Strictly speaking, under present reporting requirements for marketing co-operatives, only the final payment (which is determined after all expenses and receipts are known) is a patronage dividend. The preceding disbursements made to members during the marketing period are considered the cost of goods sold. This distinction is arbitrary, although perhaps convenient. It has little significance in the present tax treatment of such co-operatives. No differentiation is made between that part of the total payment which is actually reimbursement for the produce acquired for marketing and that part which is a disbursement of what are in fact earnings achieved through the operations of the co-operative as a business entity.

5.25 The scrip part of the payment is more or less arbitrarily determined with regard to the financial policy of the co-operative itself, as well as with regard to a satisfactory total disbursement to its members. Presumably such disbursement is satisfactory to them if it approximates what they would have received had their produce been marketed independently or through an ordinary corporation engaged in marketing. Of course, where the co-operative is acting purely as a warehouseman and the actual selling is undertaken by a Government-controlled or producer-controlled sales agency or marketing board (such as the Canadian Wheat Board), any patronage dividends paid by the co-operative, whether termed interim or final, will constitute a distribution of profit earned by the co-operative warehousing business and will not represent any part of the price of the product being marketed by the agency or board. In such a situation the agency or board usually carries out a quite separate accounting with the producers.

5.26 The proportion of scrip payment and the degree of its liquidity or marketability has an important bearing upon the continuance of membership of the producers in the co-operative where a competitive market situation exists. If the scrip is fully valued by the recipient, it is a supplement to the cash he receives; if it is not, it may be appraised by him at a considerable discount because of its lack of a fair market value. It may represent little additional real payment to him over and above the cash that he has received. In cases where a considerable proportion of the payment to the producer is made in scrip of little current value - being perhaps non-negotiable, non-interest-

bearing, and redeemable only at some indefinite time at the option of the association - and the cash return is less than some other means of marketing would have yielded, it is likely that the co-operative is in a monopsonistic position in the area which it serves, that is, its members do not have a satisfactory alternative means for marketing their produce.

5.27 Thus, the scrip part of the payment is not necessarily an indication of the earnings, profit, or income - whatever it may be called - created by the operations of the marketing co-operative. It may be more or less than what could be considered income, depending partly on the freedom of the market for the producers concerned, partly on the value they ascribe to the scrip part of their receipts for their produce, and partly on their willingness to reinvest some of those receipts in the association by holding the scrip. In other words, the non-cash allocations of the proceeds of the marketed products are at best merely a rough guide to what the earnings of the co-operative as a business entity may really be - and at worst no guide at all.

5.28 In the case of the purchasing co-operatives, non-cash allocations cannot be viewed in quite the same way. Under competitive conditions, and with prices charged to members at about the same level as those charged by other firms, patronage dividends of both cash and paper do give an indication of the earning power of the co-operative as a business entity. This would be true whether the paper had a fair market value or not, for it would represent actual funds retained by the association. Where, however, the patron-members are paying more than they need pay else-

where and the patronage dividend merely reimburses them for the difference, it would not constitute business earnings but would be merely a price rebate.

5.29 Even when this distinction is acknowledged, a serious problem remains: how to determine what part of the return made to patrons is business earnings. The less efficient co-operatives may have no real earnings at all; every cent of their patronage dividends - if they can pay any - may be purely price re-adjustment and nothing more. But inefficient co-operatives that hold, in some degree, a monopoly position are likely to have a monopoly profit that not merely subsidizes the hidden losses of inefficiency but permits the payment of substantial patronage dividends. Underlying situations of this sort is, of course, the combination of prices to the patron with the patronage dividends paid to him. Under competitive conditions the co-operative will have to do better for its members than it would where they have no alternative to its services.

5.30 Monopolistic and monopsonistic gains of co-operatives, if not siphoned off in large payments to management, will be returned to patron-members in large patronage dividends which may or may not be in such form as to have a fair market value. Where monopoly¹ power is used in dealing with patrons, presumably through a lower-than-market payment for produce in the case of marketing co-operatives and a higher-than-market price when goods are sold to patrons, the higher resulting patronage dividends may counteract the original monopoly price policy if the dividends are in cash or acceptable

1 For simplification, the term "monopoly" is sometimes used to include "monopsony".

paper. Here there may be not a true monopoly situation at all, even though the power is present and used; for the exploited are also the exploiters, and the situation merely involves a choice between more or less favorable prices to patrons and less or more in patronage dividends. When, however, prices are made relatively unfavorable to patrons through the monopoly power of the co-operative, and it pays patronage dividends in paper that has no fair market value, the picture becomes somewhat different. Patrons then are obliged involuntarily to invest further in the association.

5.31 On the other hand, where a co-operative has some monopoly power in selling its members' produce to the public, or where it has some monopsonistic power in purchasing supplies to be sold to its members, it may have a monopolistic gain that is not ascribable to any exploitation of its members with their subsequent commensurate reimbursement. There would simply be excess profits just as there would be in the case of any other business organization that had similar control in its dealings with buyers or sellers who did not share in the gains.

5.32 But this case of monopoly earnings is a special one. Even without monopoly advantage, co-operatives can have business earnings similar to those of the ordinary corporations that continue from year to year and prosper to a greater or lesser extent. Such earnings may embody an element of "pure" profit - due, say, to some fortuitous occurrence, favorable price fluctuations, the stage of the business cycle, a lag in the appropriate reward to management, or some other cause but for the most part they arise through productive activities and gainful transactions. This is equally true for co-operatives, ordinary cor-

porations, partnerships, and individual proprietorships.

5.G A Practicable Solution of the Problem

5.33 The core of the problem thus might seem to be a need to determine what part of the net margins of the co-operatives is similar to the taxable income of ordinary corporations and what part is properly to be ascribed to price adjustment. At first glance - as it is realized that each co-operative differs somewhat from every other in its methods of operation, its efficiency, and its price and patronage dividend policies - the problem might seem insoluble. It need not be however, if a practicable, though less than perfect, solution is considered.

5.34 Such a solution (although some elements in its application are necessarily arbitrary) would be based on the assumption that when purchasing co-operatives set prices at approximately the prevailing competitive level, or when marketing co-operatives purchase from their members at about the current market price, whatever gain accrues after allowance for all costs, including depreciation, represents business earnings that are at least roughly comparable to the taxable income of ordinary corporations.

5.35 It may be objected that if instead of selling (in the case of purchasing co-operatives) or buying (in the case of marketing co-operatives) at prevailing prices, an association increased its net margin by charging its patrons higher prices than those prevailing or paying lower-than-market prices for its patrons' products, that part of the net margin ascribable to the deviation of the co-operative's prices

from market prices should be excludable from its gross income. Let us agree that it should be, but the administrative as well as the compliance difficulties of accurately separating the net margin into two parts, one part taxable and the other not, would be very great. The solution - arbitrary but practicable - is to make the net margins fully taxable but permit the co-operatives to continue to transact business with their patrons at any prices, high or low, that they choose to set. Some co-operatives might decide to maximize their net margins in spite of the tax, although the tax burden at present rates would be a strong deterrent. Others undoubtedly would attempt to minimize their net margins by selling to their patrons at prices as low as possible or buying from them at prices as high as possible.

5.36 In other words, although a co-operative should be free to maximize or minimize its net margins and patronage dividends by choosing whatever pricing policy it prefers, when the pricing is at competitive levels the resulting net margins would be similar to the earnings of ordinary corporations operating under competitive conditions and properly would be subject to similar taxation.

5.H The "Pricing-Out" Question

5.37 It is sometimes supposed that if the net margins of co-operatives were taxable, the co-operatives would set their prices at such a level that only small net margins would be achieved. This possible procedure is referred to as "pricing-out." There would be, of course, no way of preventing it, for co-operatives, like all other businesses, are entitled to set prices as they see fit. But ordinary corporate business

does not fear this kind of competition, and enlightened co-operative management knows that it cannot continue in business very long with unsound pricing policies.

5.38 "Pricing-out" could lead to the destruction of a co-operative if the margin of earnings allowed for uncertainty and error were too small. Some cushioning excess of receipts over expenditures would have to be assured if, sooner or later, through unanticipated changes in costs and prices, as well as in general economic conditions the co-operative were not to find itself in financial straits. The history of the co-operative movement is replete with failures due to pricing that resulted in too small a difference between receipts and expenditures. That price policies might be adopted, to some extent, to mitigate the taxation of net margins is possible, but it is unlikely that the change would be extreme or that it would by any means do away with net margins.

6. THE TAX PRIVILEGE ACCORDED CO-OPERATIVES IS
INEQUITABLE AND UNECONOMIC, AND IT DEPRIVES
THE GOVERNMENT OF NEEDED REVENUE

6.1 Because equity and economy are fundamental principles of taxation and tax exemption, emphasis here will be placed upon the ways in which the present tax treatment of co-operatives' income violate those principles with consequences that are adverse to the public interest. The resulting loss of revenue to the Government, although substantial, is incidental to considerations of equity and economy.

6.A The Privilege Is Inequitable

6.2 There are two grounds for holding that the tax privilege is inequitable: (1) It discriminates between two essentially similar sources of revenue; and (2) it results in an unwarranted competitive advantage for the co-operative corporations.

6.3 As has been shown, the controlling fact in the controversy as to whether co-operatives should be fully subject to the corporation income tax is that they have the same kind of income as that of other business corporations which are subject to the tax. The privilege of deducting or excluding a large part of what is earned by a co-operative is thus an unwarranted discrimination.

6.4 The magnitude of the discrimination and of the tax burden upon the corporations that are fully taxed, is apparent in the rates to which those corporations' income is subject. The rates, to which co-operatives' income also would be subject if the deduction or exclusion of patronage dividends were not allowed, begin at 21 per cent and go as high as 52 per cent.

6.5 The most pronounced effect of this inequity is upon the competitive position of co-operative and ordinary corporate business organizations that deal in the same products in the same market areas. As tax rates on corporation income increased, what was once a small tax saving for co-operatives became a source of capital that gave most of them a marked financial advantage over their ordinary corporation competitors. Large tax savings permitted many co-operatives to expand far more rapidly than would otherwise have been possible. Tax-free income has continually enabled many of them to increase their facilities and services at an accelerated rate and, also, in numerous instances, to buy out their competitors.

6.6 For the more efficient co-operatives, substantial tax savings also have enabled them to offer prices more favorable to all who might deal with them than could be offered by competing ordinary corporations. To a business with such an advantage, the attraction to potential patrons can be irresistible. Such co-operatives have the power, through their pricing policies, to put equally efficient ordinary corporate competitors out of business. The establishment of new firms that would not have the co-operatives' tax advantage is also undoubtedly discouraged. There is apparent in the discriminatory tax treatment of co-operatives both a subsidy of capital for them and a subsidy of prices for their member-owners. Either subsidy may be given preference, depending upon the policy of a co-operative's management.

6.7 The inequity appears in another important way. Earnings of corporations that are not co-operatives can be capitalized at little more than half the amount

that would be possible were they co-operatives. This is apparent when a co-operative undertakes to acquire an ordinary corporate business.

6.8 For a simple example, using round figures, let us assume that the ordinary corporation employs \$5,000,000 of capital and has annual earnings of \$1,000,000 before payment of the income tax. Its earnings after payment of the tax would be about \$510,000. If, however, it were a co-operative employing the same amount of capital and having the same amount of earnings before payment of income tax, it would have a tax liability of less than \$70,000. Its earnings after payment of the tax would be about \$930,000. Assuming that the current rate of return on capital invested in this particular kind of business is 10 per cent, a co-operative might be willing to pay as much as \$8,700,000 in order to acquire the ordinary corporation and transform it into a co-operative. (Allowance is made for an additional \$55,000 per year of income tax - 50 per cent of 3% of \$3,700,000 - that would have to be paid because of the enlarged capitalization of the acquired firm.)

6.9 Another ordinary corporation that might have wanted to buy the business could prudently have paid no more than the capitalized value, after taxes, of about \$5,000,000. Actually a co-operative might acquire the business for not too much more than the after-tax value of \$5 million, for that would be all that the business was worth to its tax-burdened proprietors. By such legerdemain, in which the assets and earning power of a fully taxed corporation are transferred to a corporation subject to a much lower tax, \$370,000 of annual earnings or about \$3,700,000 of investment value can be

created free and clear for the tax-privileged buyer - the co-operative.

6.10 That co-operatives have acquired, and are continuing to acquire, proprietary businesses both from within and from outside their industries is a well known fact. Perhaps not all such acquisitions are due to the co-operatives' ability to capitalize income freed from taxation, but unquestionably many of them are.

6.11 This is the stark realism of the co-operatives' tax advantage that has instilled fear in the minds of their ordinary corporate competitors, for the latter know that in many cases the co-operatives can either compete them out of business or buy them up at far less than the full capital value of their earnings before taxes.

6.B The Privilege is Uneconomic

6.12 To fortify the argument that co-operatives should be taxed in the same way as ordinary corporations, it is worth-while to show that they are not a superior form of business organization; that their tax advantage impairs competition and leads to a poorer allocation of the Nation's resources than would otherwise occur; and that in cases where co-operatives are equal or superior in efficiency to competing businesses, they have no need for the tax advantage now accorded them.

6.13 For clarity of analysis most economists assume that those who supply the various agents of production - land, labor, capital, and entrepreneurship - seek to obtain the greatest possible return for their participation in the productive process, and that consumers endeavor to maximize their spending power. Presumably, the form of business organization chosen by an entre-

preneur or an entrepreneurial group (whether investors and businessmen seeking a return on capital and profits, or an association of producers or consumers intending to serve themselves through co-operative organization) is that which will enable them to attain most effectively their objective, namely, the greatest possible gain to themselves.

6.14 Whether the business is to be an individual proprietorship, a partnership, an ordinary corporation, or a co-operative depends upon a complexity of circumstances that must be evaluated by those concerned. The urge to maximize opportunity for gain is, however, just as much present in the selection of the form of organization as it is later in the operations of the business. When a co-operative association is the form chosen, it has been determined upon because its prospective owners believe it to be the best means for benefitting themselves.

6.15 Taxes and future tax prospects are important considerations in deciding upon the form that an enterprise will take. If taxes are inordinately high and fall upon business very unevenly, they influence that decision. Since the earnings of co-operatives are largely free of tax at the co-operative level, so great an advantage for co-operative enterprise must often weigh heavily in the balance when that form of organization is chosen.

6.16 If co-operatives, free of subsidization or tax advantage, could be shown to be economically superior, a strong though not completely positive case might be made for their encouragement and extension, although whether encouraged or not, they would surely tend to become the predominant form of business organization.

However, there appears to be no common characteristic of co-operatives that could make them an economically superior form of business organization.

6.17 The inequity and the uneconomic distortions due to the tax advantage are conducive to actual and potential monopoly power in various degrees for many co-operatives. Government favoritism for the co-operatives in other ways besides that of tax subsidization may also increase the co-operatives' competitive advantage.

6.18 Within a particular co-operative, of course, the members have ceased to compete among themselves in marketing their products or in purchasing services or supplies. As co-operatives have joined together in federations, and they too have ceased to compete among themselves, they have formed larger, stronger organizations for advantageous bargaining in a broader area of the economy. In the trend to co-operative federation and co-operative integration of various stages of production and marketing, competition within ever larger groups has been done away with and bargaining power has been greatly enhanced.

6.19 Thus, the monopoly power of co-operatives, as it is derived from integration and from Government favoritism in various ways, and as it is enhanced by the tax privilege, presents a grave problem not only for the co-operatives' unfavored and fully taxed competitors but for the national economy. Such institutionalized favoritism in the course of time conceivably can change the nature of the economic system.

6.20 It is an established and widely accepted principle in economics that the freer markets

are from monopolistic and other restraining or distorting influences, that is, the more fairly competitive the economic system is, the closer the economy will be to the most economical use of its resources. This is the underlying principle of the free competitive enterprise system.

6.21 As for the effects of monopoly or monopolistic elements upon the productivity of an economy, there is great accord among economists. Practically every text that deals with economic analysis draws the same conclusions. (The full analysis is mathematical and somewhat elaborate and complex.¹) Summarized, those conclusions are that where a monopolistic element exists: output is lower, prices are higher, employment is less, and resources are less effectively allocated than where competition is unhampered.

6.22 A co-operative, when it lacks monopoly power or special privilege, is a competitive business entity. Its survival and growth depend, then, upon its efficiency, which in turn depends upon the wisdom of its directors in larger matters of decision and upon the ability of its management at the operational level. Its value to the nation is determined by the real costs at which it provides its services. Like any firm in a freely competitive situation, its survival depends upon relatively low unit-cost of output that is, upon the economical application of labor, capital, and managerial effort to the particular productive processes in which it engages. The co-

1 See, for example, Kenneth E. Boulding, Economic Analysis, revised edition (New York: Harper and Brothers, 1948), Chapters 25 and 26.

operative way of doing business is as good a way as any other when it has no special privilege and can survive under competitive conditions.

6.23 If, however, to a greater or lesser extent, a firm - whether it is a co-operative or any other form of enterprise - is subsidized by a tax advantage, a part of its real costs of operation is borne elsewhere in the economy, directly by Government and indirectly by all who contribute to pay the expenses of Government. Because the tax subsidization of co-operatives has been conducive to the establishment and survival of higher-cost, less efficient business units throughout the economy than would otherwise be possible, this is not to say, however, that all co-operatives, because they enjoy a tax advantage, are high-cost inefficient businesses.

6.24 The subsidy that the tax advantage gives all co-operatives, except those that have no earnings at all and so would not be subject to an income tax, permits many of the inefficient and uneconomically operated ones to survive when otherwise they could not do so; and it permits the more efficient co-operatives to expand their operations beyond what would be a point of insufficient return were their earnings from that expansion subject to tax. Underlying this statement is the fact that every business must produce a sufficient return on the capital invested in it or in due time the capital will be shifted to some more profitable investment.

6.25 If, for example, the going rate of return on capital used in business is 5 per cent (after an allowance in earnings has been made to compensate for

the risk involved in the investment), a firm earning only 4 per cent is comparatively inefficient. Firms earning even less than that or sustaining losses are, of course, even more inefficient. Under free competitive conditions, those that remain inefficient tend to be liquidated, the part of their capital that has not been dissipated being transferred to better paying opportunities. Under such conditions there is a continual shifting of capital from business activities that are less productive of earnings to those activities that earn more because they are more needed or wanted for supplying the public with goods and services.

6.26 Thus a Nation's capital resources continually tend to be used at their highest possible level of productivity when no obstacle, such as tax subsidization, hampers or prevents that shifting. Likewise, the effort of workers, the Nation's human resources, is most productive when it is not induced by tax subsidization, or some other arbitrary influence, to remain in comparatively inefficient business situations.

6.27 Co-operatives range in efficiency from a very high level to the very lowest where survival hangs from day to day on a thread of chance. Also along this same continuum of efficiency are all ordinary corporate businesses, except that the respective firms - so long as they have some earnings that are subject to tax - will have smaller net earnings after tax than the net earnings of the equally efficient but tax-favored co-operatives.

6.28 If, except for the co-operatives' tax advantage, an ordinary corporation and a co-operative

were equal in every respect, including the amount of their earnings and the percentage of earnings to capital, the earnings of the ordinary corporation after payment of the income tax would be much less than the after-tax earnings of the lightly taxed co-operative. For example, if under the present tax statute each earned \$100,000 in a given year, the proprietary corporation's earnings after tax would be \$60,150, but the co-operative's earnings after tax would be \$90,000 to \$100,000 depending upon its capitalization and the extent of its borrowings. If the capital of each were \$1,000,000, the return on the proprietary corporation's capital would be about 6 per cent and the return on the co-operative's capital would be 9 to 10 per cent, the higher figure being realized in situations where the co-operative employs substantial borrowed funds on which the interest would be deductible from taxable income.

6.29 Again, for example, if a proprietary corporation continually has earnings that are little more than sufficient to reward capital at the current rate but those earnings are reduced by from 21 to perhaps 52 per cent because of the income tax, that business thereby becomes submarginal and in the longer run its failure or liquidation is almost assured. But a co-operative of no better than equal efficiency may survive because its tax burden is smaller. Under present tax conditions, where earnings fluctuate widely from year to year an ordinary corporation will have much less surplus that can be set aside to sustain it in the lean years than has a co-operative of similar size and

efficiency.

6.30 There is no way to determine just how many proprietary corporations have dropped by the way because of inroads made on their earnings by the income tax; nor can it be known how many never came into existence because marginal co-operatives could survive but proprietary corporations at, or well above, the same level of business efficiency, could not. It is the marginal and near marginal co-operatives (and the part of the operations of other co-operatives that is an extension made possible only by tax advantage) that use a part of the Nation's resources less effectively (and therefore wastefully) than they might be used by businesses that because of tax discrimination either cannot come into existence, stay in existence, or expand to their optimum level of productivity.

6.31 When the effect of some co-operatives' uneconomic operations is made up for or exceeded, so far as those particular co-operatives are concerned, by the gain through their tax advantage, the loss is borne first by the Government and finally by the whole economy. However, a distinction must be made between co-operatives that are at least as efficient as their ordinary corporate competitors and those that are less so. In a relatively free market economy, where there were no tax advantage, the less efficient co-operatives and the less efficient proprietary corporations both would tend to disappear; the superior businesses, whether co-operative or otherwise, would remain.

6.32 When a co-operative is inefficiently operated, it may continue its inefficient operations indefinitely; and though the diseconomy may be con-

cealed, it is shifted through the tax privilege so that it becomes a charge upon the rest of the economy. When the co-operative is so inefficiently operated that the tax subsidy just enables it to stay in business no one gains (the members of the co-operatives could do as well by dealing with a proprietary corporation) and everyone who is a taxpayer loses.

6.33 But when a co-operative is sufficiently well operated so that some part or all of its tax subsidy is not needed to keep it in business, the part of the subsidy not needed to cover what would otherwise be loss becomes a gain to the owner-members, whether it is distributed to them as patronage dividends or in especially favorable prices.

6.34 Thus, whether the members of a co-operative gain the whole amount of the tax subsidy or only the part of it not needed to cover loss, the entire amount of the subsidy is paid through taxation by the rest of the economy. The question why everyone else should thus contribute to members of co-operatives has never been satisfactorily answered. That gain has no justification, for the recipients have done nothing to entitle them to it. It results entirely from the fact that they are owners of a highly tax-favored kind of business corporation rather than owners of a corporation that is subject to the high rates of the income tax.

6.C The Privilege Deprives the Government of Needed Revenue

6.35 There is no accurate way of determining how much revenue is lost by the Government through the tax privilege accorded co-operatives. A reasonable

estimate would appear to be in the region of \$25,000,000 annually.¹ The addition to the Government's receipts of some such amount would ease somewhat the fiscal problem, or it could lessen somewhat the over-all tax burden. However, this loss of revenue to the Government is of small significance compared with the inequitable and uneconomic effects of the tax discrimination, the losses from which, although indeterminable, may be many times the amount of lost revenue.

1 Perhaps another \$25,000,000 of revenue loss is due to the tax-exempt status of credit unions, which thereby have an advantage over their ordinary corporate competitors in much the same way as the co-operatives have an advantage over their ordinary corporate rivals. A reasonable estimate of the total income tax subsidy to Canadian co-operatives and credit unions is therefore in the neighborhood of \$50,000,000.

7. THE CO-OPERATIVES' TAX ADVANTAGE PROMOTES THE
DEVELOPMENT OF A CO-OPERATIVE STATE

7.1 The ideological goals of a Co-operative Republic and a Co-operative Commonwealth (the former to be a nation-wide and the latter a world-wide economic system comprised largely or entirely of co-operatives) may not be as visionary as many defenders of the free competitive enterprise system like to suppose. Although the economies of Canada and the United States are still far from being largely made up of co-operative businesses, the substantial progress of the co-operative movement in both countries in recent decades may foreshadow a further and perhaps accelerated development.

7.2 How far the co-operative movement may be carried by the impetus given it from present tax provisions so favorable to it cannot clearly be predicted. Although co-operatives even today are a comparatively small part of the business structure in Canada and the United States, this does not mean that in the long run they could not become the dominant business form. The ordinary corporation, not too long ago, was the exceptional form of enterprise, but it became a common form because of the economic and financial advantages it afforded for many kinds of business. The tax advantage now accorded the co-operative form of organization may be similarly fostering, although without similar economic and financial justification, a great extension of co-operative enterprise.

7.3 A co-operative state and a co-operative world are goals sought by idealistic individuals who believe that through the application of co-operative principles to practically all economic activity a new

and better way of life can be found. Such persons represent an extreme segment of the many who see in the co-operative way of doing business various degrees of merit. Of the several million members of co-operatives in Canada and the United States, only a small percentage envision the co-operative millenium. Most of them are matter-of-fact, down-to-earth individuals who are reasonably satisfied with the prevailing economic system. They look upon their co-operatives as an integral part of that system and as one of various means by which they can further their own material interests. Although most members of co-operatives have no interest in a wholly co-operative economic system, they have generally taken for granted, and regarded as benign, the marked tax advantage Government has accorded the co-operative movement, not realizing the longer run effects of such discrimination upon the system under which the great majority of them have prospered.

7.4 The proponents of the Co-operative State seem to agree that it would be based on a collective rather than a free-market economy; that it would be a variant of socialism or communism; and that it would evolve gradually at first, within the present system and without the violence of sudden revolution, although its achievement would be, in effect a revolution of the economic order.

7.5 Ernest Poisson, an outstanding authority on the co-operative movement, has said:

"The complete Co-operative Republic, like the Social Republic, would achieve collective ownership of the means of production and exchange. Co-operative organi-

zation and socialization are thus two allied if not synonymous terms.....

"Certain socialists in describing their ideal have indeed said that they conceive society as a huge co-operative organization. Did not Kautsky, the great Marxian theorist, write 'What is the socialist system if it is not a co-operative society extended and universalized?'.....

"Nevertheless the Co-operative Republic possesses the peculiar attribute of being now and henceforth, in the very midst of capitalism, the rudimentary form of that new society in which there shall be no classes...."¹

7.6 The well-known British authority on communism, Harold J. Laski, saw in the co-operative movement a trend opposed to capitalism:

"The essence, I say, of Co-operation is a denial that the profit-making motive can ever produce a just or humane society. My inference from this is the vital one that between co-operation and capitalism there can be no peace. They are mutually exclusive conceptions of society."²

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- 1 Ernest Poisson, The Co-operative Republic, translated from the French by W. P. Watkins (London: T. Fisher Unwin Ltd., 1925, pp. 89, 92, 100, 104-5, 109.
 - 2 Harold J. Laski, The Spirit of Co-operation (Manchester: Co-operative Union, Ltd., 1936(?), p. 8.

7.7 If the Co-operative Republic and the Co-operative Commonwealth could be achieved, almost certainly they would be far less democratic than their idealistic proponents imagine. The basic principles of simple co-operation of the Rochdale type could not conceivably apply to a state of complete co-operative activity. Membership could not participate in management, and membership control over management would, at most, be remote and indirect. That is already the case with the larger co-operatives and federations of co-operatives. It would not be less so in the Co-operative Republic.

7.8 If the co-operative movement were sufficiently extended, the fundamental difference between the profit-maximizing motive of the producer co-operatives and the consumption-maximizing motive of the consumer co-operatives probably would mean the eventual absorption, control, and operation of the producer co-operatives by the consumer co-operatives.

7.9 There would be a complete monopoly of the economy - a monopoly the movement's partisans might say, of the consumer, by the consumer, for the consumer. They overlook the likelihood that not only in the role of consumer but also in that of worker and investor, the individual's wants would be subordinated to the requirements of the great co-operative machine. The individual would relinquish his sovereignty as consumer, which he enjoys under a system of free enterprise and free markets and which now directs production to meet his demands. As worker and investor he would have no choice but to serve the great national co-operative. The attainment of the co-operative economy would almost certainly mean the subservience of the individual to the

group.

7.10 Other implications for individual freedom need merely be mentioned, for they are the same that would obtain under any other system of collectivism. Economic planning and control, whether by Government officials or by the top management of a nation-wide, over-all co-operative (which would soon either fall into the hands of Government or become Government itself), could mean the power of life and death over the individual. It would be the sole employer of labor and the sole purveyor of the means of sustenance. It could punish and reward as each case seemed to require. Who could speak out against it or seek to change the established order?

7.11 If it were not for the very substantial tax advantage accorded co-operatives, one would not need to give a second thought to the possibility of a Co-operative State. Only under the most favoring and artificial circumstances, including grossly inequitable tax favoritism, could that system come about. The two points to be made here are: first, that the co-operative way of doing business is not necessarily the most efficient and economical way, and that therefore under freely competitive conditions co-operatives cannot displace all other forms of business; and second, that only under long-continued, heavy subsidization of co-operatives, at the expense of other forms of business, could they conceivably gain the necessary ascendancy by which to resolve themselves into a complete co-operative society.

8. THE PLACE OF CO-OPERATIVES IN A
FREE-ENTERPRISE SYSTEM

8.1 When seen in perspective, the place and role of the co-operative in a free-enterprise system is not difficult to determine. There the co-operative is simply one of a variety of profit-seeking business organizations. It is in competition with other forms of business and may be in competition with other co-operatives as well. A particular co-operative may be superior or inferior to its business rivals in the efficiency of its operations, depending upon a combination of circumstances, but it cannot be a more efficient business entity just because it is a co-operative. The supposition that somehow it is therefore more efficient is the major fallacy of the co-operative movement.

8.2 In a competitive economy each business firm finds its place and survives or fails on the basis of its ability to use manpower and capital more effectively. That no economy can be perfectly competitive - though its drive may continually be toward that ideal - cannot be an argument to justify privilege and monopoly practices for either the co-operative or other forms of business.

8.3 How can it be proper public policy, then, to favor the establishment, growth, and expansion of co-operatives if they are not a superior form of business? And if it could be shown that they are superior, why then should they need favored tax treatment or other special privilege rendered by Government?

8.4 The answer is plain: without subsidy of any kind, each co-operative would find its rightful place in the economy in the same way that other, unfavored,

business must. The whole nation would be better off. Its capacity to produce would be used more fully and effectively. A part of its resources would not be wasted in support of economically inferior business units.

8.5 There is, and always has been, a place for the co-operative in a free economy. How extensive the co-operative form of business may become, and what part of the Nation's total business will be transacted by it, ought to depend solely upon its unsubsidized ability to serve the public economically.

9. CONCLUSIONS

9.1 Under Sections 73 and 75 of the Income Tax Act, co-operative business corporations can and do escape a large part of the tax that falls upon other business corporations.

9.2 Although spokesmen for the co-operatives have formulated doctrines and devised special terminology in an attempt to justify their organizations' tax-favored status, the incontrovertible fact remains that the co-operatives are business corporations earning the same kind of income as that of the fully taxed ordinary corporations.

9.3 Co-operatives are not eleemosynary associations, nor are they partnerships or agencies. They are corporate business enterprises seeking gain for their members.

9.4 The marked tax discrimination favoring co-operatives cannot be shown to be in the public interest, because it leads to less than the fullest use of the Nation's resources.

9.5 The co-operatives' tax advantage could be conceivably the opening wedge for a collectivist society, in which the form of business organization would be predominantly or exclusively co-operative, with all the adverse implications for economic freedom that are inherent in centralized, over-all direction and control of economic processes.

9.6 The loss of revenue to the Government, due to this tax discrimination, although of less importance than the resulting inequities and diseconomies, should be taken into consideration.

9.7 The discrimination is inequitable not

only because it taxes heavily one form of business corporation while taxing lightly another, but also because the whole tax burden is thereby made somewhat heavier for all who have to bear it.

9.8 The present high rates of the corporation income tax have intensified the effects of the discrimination both by making co-operative membership highly advantageous in many instances, and by allowing, through retained earnings lightly taxed, a more rapid expansion of co-operative enterprise than is economically justified.

9.9 The greater profitability and the consequent competitive advantage of co-operatives, due to their favored tax status, have been a strong inducement for some ordinary corporations to sell out to their co-operative rivals or to transform themselves into co-operatives.

9.10 The tax advantage has given some co-operatives the power to destroy or absorb their heavily taxed competitors, even when the latter may be more efficient businesses.

9.11 Under conditions of tax equality, the co-operative corporations would pay the full corporation income tax without allowance for any deduction of patronage dividends, and patronage dividends would be taxed to the recipients in the same way that the dividends of ordinary corporations are taxed to their recipients.

9.12 The problems arising from tax provisions that grossly favor the co-operatives can be solved by legislation that would place co-operatives and their members on the same basis as ordinary corporations and their stockholders with respect to the income tax.

10. RECOMMENDATIONS

10.1 That Section 73 (1) of the Income Tax Act, which provides full exemption from the income tax for three years for newly-formed co-operatives, be repealed;

10.2 That Section 75 of the Income Tax Act be so amended that patronage dividends, whether of co-operatives or of ordinary corporations, no longer be deductible in computing taxable income;

10.3 That patronage dividends be taxed to the recipients in the same way that the dividends of ordinary corporations are taxed to the recipients, and that whatever deduction or credit is allowed for either kind of dividend be allowed for the other.

All of which is respectfully submitted.

Robert T. Patterson

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SUBMISSION

to the

ONTARIO COMMITTEE ON TAXATION

**THE TAX TREATMENT
OF CO-OPERATIVES
AND THE ECONOMIC EFFECTS
OF THEIR PRESENT
TAX-FAVORED STATUS**

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